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December 11, 1998

EXPARTE

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: CC Docket No. 95-116 – In the Matter of Telephone Number Portability

Dear Ms. Salas:

Attached is a report written by Timothy J. Tardiff which answers and explains questions posed in an October 30, 1998 exparte attended by SBC and members of the Competitive Pricing Division on the above subject. The report addresses the question of whether or not the prices for current price cap services fully recover the Incumbent Local Exchange Carriers' (ILECs') common costs and accordingly, if including any recovery of such costs beyond what the Commission has characterized as incremental overhead costs in the prices of new services (or network functions) such as LNP, could produce double recovery of such costs.

In accordance with 47 C.F.R. 1.1206(a)(1) of the Commission's rules, the original of this letter and one copy are being filed with your office. Acknowledgment and date of receipt are requested. A duplicate of this letter is included for this purpose.

Please direct any inquiries concerning the foregoing to the undersigned.

Very truly yours,

Chris Jines
Attachment

CC: Jay Atkinson
Chris Barnekov
Lloyd Collier
Ana Ganckson-Curtis
Rhonda Lien
Kris Monteith
Josephine Simmons
Lennie Smith

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Measuring and Recovering the Costs of Long-Term Number Portability: Implications of Price Cap Regulation

By Timothy J. Tardiff

December 10, 1998

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Introduction

In our previous discussion of the identification and recovery of long-term number portability costs, we concluded that efficient prices for these services and other services produced by incumbent local exchange carriers (ILECs) as well as balanced competition among ILECs and competitive local exchange carriers (CLECs) dictate some recovery of common overhead costs in the rates charged for local number portability services.¹ Our discussion was general in nature, and as such did not explicitly address the type of regulation imposed on the ILECs. The purpose of this discussion is to respond to a question from the FCC staff as to whether there are specific features of price cap regulation that would cause us to modify our basic prescription. The answer is “no”; our conclusions apply equally well to a price cap regulated firm.

In particular, we address the question of whether or not the prices for current price cap services fully recover the ILEC’s common costs and accordingly, if including *any* recovery of such costs beyond what the commission has characterized as incremental overhead costs in the prices of new services (or network functions) such as LNP could produce double recovery of such costs. Our conclusion does not depend on the appropriateness of treating LNP recovery under a price cap regime, but simply accepts the tenet of the question that current provisions for pricing new services² are applicable for LNP. These provisions, which allow for prices

¹ Alfred E. Kahn and Timothy J. Tardiff, “Measuring and Recovering the Costs of Long-Term Number Portability,” October 28, 1998, pp. 7-9.

² Treating LNP as new services under price caps would introduce a number of implementation issues that are beyond the scope of this discussion, e.g., which basket(s) to place LNP services and how to appropriately index charges that to a large extent recover one-time capital investments over a pre-specified amortization period. Alternatively, because LNP services are being added pursuant to the Telecommunications Act of 1996, they may be viewed as an exogenous change for price cap purposes. In this case, the precedents for treating exogenous costs have been based on fully distributed costs, which include some recovery of common costs.

above bare incremental costs, can be viewed as a mechanism that allows ILECs to approximate the way they would price unregulated competitive services.

LNP services are new

Two types of rates for LNP services will be established: (1) an end-user charge to recover the costs for network enhancements that allow customers to retain their current phone numbers when switching local exchange carriers and to complete calls to ported numbers, and (2) a charge to other carriers for using the database query services provided by ILECs. Both types of services clearly represent new network capabilities. In the case of query services, ILECs will be competing against other data base providers as well as firms that self-provision these services.³ Therefore, the established pricing rule for new services makes sense for LNP services, especially so for the query services offered on a competitive basis to other carriers.

New service pricing under price caps

When a new service is introduced under price caps, it is treated outside of the price cap index in the year it is introduced. The price itself must *at least* cover its direct costs.⁴ In other words, this initial price will typically be higher than incremental costs, thus recovering some of the ILECs common overheads in the process. In subsequent years the new service and its initial price are folded into the appropriate basket and treated as existing services.

Notice that there is no restriction on the amount of mark-up over cost (and implicit recovery of common overheads) in the initial price based on an assessment of the recovery of common overheads in the prices of existing services. Rather, the recovery of overheads is

See, for example, In the Matter of Tariffs Implementing Access Charge Reform, Memorandum Opinion and Order, CC Docket No. 97-250, June 1, 1998 ¶ 80 and 85. In either case, the price would include more than the mere direct cost of LNP.

³ Because the purpose of LNP is to facilitate competition among local exchange carriers, the end-user charge would also be subject to competition to the extent that local exchange competition materializes. Accordingly, basing the rate for end-user charge on the assumption that customers are captive to the ILECs is inconsistent with the very rationale of mandating LNP—to facilitate local exchange competition.

⁴ 47 C.F.R. § 61.49.

based on reasonableness, taking into account the ILEC's need for pricing flexibility.⁵ There are several sound reasons why such an assessment based on the prices of existing services would be inadvisable. First, as the FCC itself as pointed out,⁶ even though price caps start with an alignment of prices and *accounting* costs, the subsequent operation of price caps can cause prices and costs to deviate, i.e., there is no requirement that prices for current services exactly recover current costs (including common overheads), nor should there be.

Second, the starting prices are based on *accounting* or fully allocated historical costs, rather than forward-looking incremental costs. Therefore, even at the beginning of the price cap period, there was no assessment that current services exactly recover forward-looking common overheads

Third, and most important, the new services provisions provide pricing flexibility and management discretion that is rightfully intended to approximate that available in unregulated markets. Allowing new services to recover common overheads in the initial prices and then allowing pricing flexibility for these new services in conjunction with existing services means that prices and the concomitant recovery of common overheads will be responsive to market conditions, rather than determined by a price formula. And this is precisely what price cap regimes are intended to accomplish. It would indeed be strange and positively counterproductive to limit the pricing flexibility for new services based on the historical accident that previous services have putatively already recovered all the firm's common overhead costs. Even if *arguendo* the pricing of new services causes prices in the aggregate to depart from costs, the overall pattern of these prices would be superior to regulatorily-imposed

⁵ In the Matter of Amendments to Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 89-79, CC Docket No. 87-313, July 11, 1991, ¶44.

⁶ See, for example, In the Matter of Tariffs Implementing Access Charge Reform, Memorandum Opinion and Order, CC Docket No. 97-250, June 1, 1998 ¶ 72 and In the Matter of Access Charge Reform, CC Docket No. 96-262, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Transport Rate Restructure and Pricing, CC Docket No. 91-213, End User Common Line Charges, CC Docket No. 95-72, First Report and Order, May 16, 1997, ¶ 26. ("Access Charge Restructure Order")

prices that slavishly aligned new prices with current prices plus whatever was left to recover of common overheads.⁷

Conclusion

Economic principles make it obvious that the rates for LNP services should provide for recovery of the ILECs' forward-looking common overhead costs. The assumption that the ILECs are operating under the FCC's price cap regime does not alter this basic conclusion. In fact, the very rationale for price caps—providing incentives that better match those facing unregulated firms than those provided by cost-based regulation—and the FCC's provision for pricing new services comport completely with the inclusion of a mark-up over direct cost for recovery of overheads that is found in competitive situations. LNP is conclusively a competitive new service. There is no economic basis for according it unique cost treatment if it is to be included within price caps.

⁷ In its Access Charge Restructure Order, the FCC observed the following:

Economic logic holds that giving incumbent LECs increased pricing flexibility will permit them to respond to competitive entry, which will allow prices to move in a way that they would not have moved were the pricing restrictions maintained. This can lead to better operating markets and produce more efficient outcomes. (¶ 270)